EU ring-fencing and the defence of too-big-to-fail banks

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TOO BIG TO SEPARATE?
EU RING-FENCING AND THE DEFENSE OF TOO BIG TO FAIL BANKS

Abstract
Bank ring-fencing is the attempt to separate ‘higher risk’ banking activities from those activities seen to be more socially useful to the real economy. It is also an important post-crisis regulatory response to the moral hazard dilemma surrounding Too Big To Fail banks. Since national governments bore the worst of the costs of rescuing the largest banks it is therefore reasonable to assume that the authorities would have the greatest incentive to promote tough ring-fence reform. In confrontation with the EU’s Liikanen Group and the EU Commission however, France and Germany established a weaker set of national reforms. Our article asks why these national governments pursued a set of laws that were more accommodating to their largest banks than the EU proposals? We argue that France and Germany were defending market-based banking in their largest universal banks. What is most significant though is that they were therefore defending the ability of their largest banks to hold large volumes of trading assets which, in the view of the EU Commission and others, was a major cause of the financial crisis. Our conclusions have important implications for the Varieties of Capitalism literature and suggest that the direction of change in these countries will continue to be towards further market-based banking, despite the associated costs revealed by the crisis.

Introduction

This article focuses on bank ring-fencing, an important issue in post-crisis reform. The idea behind ring-fencing is to protect the domestic economy. Bank structural reform or 'ring-fencing', is the separation of certain banking activities, with the aim of insulating one part – usually what are seen as the more socially useful deposit-taking and lending functions – from difficulties in the more risky trading activities. Ring-fencing is therefore seen as a way of preventing the impact of these trading activities on the real economy through reduced lending by banks that both trade and lend, and of reducing the need for governments to bail-out all banking activities, regardless of their direct importance to the domestic economy. They also represent a potentially significant constraint on banks' activities.

The need to limit the exposure of the real economy to trading activities was a central theme of the G20 Pittsburgh summit (G20 2009). What followed were a host of ring-fencing reforms and recommendations: the Volcker rule in the US; the Vickers Commission proposals in the UK; and then the EU's Liikanen Report and EU Commission proposals. In the background however, as the EU was producing its proposals the Belgian, French, and German authorities were developing their own national-level reforms. Whereas the EU's Liikanen recommendations (September 2012) and the final EU Commission proposals (January 2014) proposed relatively tough versions of the ring-fence, the French and German authorities in particular put in place much 'lighter touch' ring-fence laws. Our paper therefore asks: why did the French and German authorities pursue an approach that was more accommodating than the EU authorities towards their banks?

Our argument comes in two parts: first, we address the domestic politics of the ring-fencing issue. Though the national ring-fencing debates unfolded as a response to failures of domestic banking systems, they were fundamentally shaped by the EU's tougher approach, as it came to light. Second then, we explore how the French and German banks and authorities tried to defend their domestic reforms during the EU-level negotiations. Here we explain the disjuncture between what the national actors *said* about the tougher EU ring-fence – that it would harm domestic lending – and what they were actually trying to achieve. We argue that the national actors were actually seeking to defend 'market-based banking' (Hardie et al. 2013; see below) and national champions in investment banking in France and Germany in particular (for an overview of 'economic patriotism', see Mügge and Stellinga 2010; Clift and Woll 2014; also Howarth and Quaglia, *this issue*). The reasons behind EU preferences are beyond our scope, but we argue that the *purpose* of the EU and national reforms were at odds: where the EU was seeking to promote more substantive change in banking structures, national authorities were using their reforms to protect the status quo. The recent financial crisis had demonstrated to many, including the generally market-friendly European Commission, that the status quo in banking carried enormous risks, most clearly for national economies. Yet the French and German authorities chose not to constrain their own large banks in any material way.

Our conclusions have important implications for the debates on Varieties of Capitalism and market-based banking (MBB) after the financial crisis. A finding that the French and German authorities acted in defense of their domestic private actors is of course not in itself a highly significant addition to the existing literature, even in a confrontation between the Commission and national authorities. The main significance of the ring-fencing dispute lies rather in the details of what France and Germany were defending and why. Both France and (particularly) Germany are widely seen in the CPE literature as bank-based financial systems, heavily dependent on bank lending for the financing of non-financial corporations (NFCs). Varieties of capitalism approaches have therefore tended to posit a dichotomy of bank-based continental European versus (capital) market-based Anglo-American systems (Zysman 1983, Hall & Soskice 2001), with governments acting in defense of the actors in their particular system.

A number of accounts in the lead-up to the financial crisis highlighted that alongside processes of *liberalization,* states – including France and Germany – were also actively *making markets* (Deeg 2005; Clift 2011; Howarth 2013; O'Sullivan 2007). This process of change was apparent within the long-standing bank- / market-based dichotomy: the change was 'from bank domination to markets' (Deeg 2005, 333). The large banks also supported many of these developments, since these changes aided the banks' investment banking strategies, which focused on fee-based advisory and intermediation services (Erturk and Solari 2007). In other words, large banks exploited the shift towards markets for their fee- and commission-based business. However, financial system change was also increasingly the result of changes taking place *on the balance sheets* of the banks, especially the largest, with the rise of 'market-based banking' (Hardie et al. 2013; Hardie and Howarth 2013). This included huge increases in the trading assets of banks (on France and Germany, Hardie and Howarth 2009). In other words, before the crisis, French and German governments supported financial market developments which would provide alternatives to bank-based finance. The reaction of the banks increased their own role in financial markets by way of increased trading assets. Yet the result, post-crisis, is that the French and German ring-fencing reforms are now defending these (market-based) banking activities.

The Liikanen report and the EU Commission, in their ring-fencing proposals, were motivated by a desire to reverse these pre-crisis developments: to reduce the 'excessive trading and market-based activity' that were - they argued - perhaps the key factor in explaining the crisis (Commission 2012: 64). Immediately post-financial crisis, then-French president Nicolas Sarkozy seemed to concur, claiming the world 'had turned the page on the Anglo-Saxon model'. German government officials also (ostensibly) broadly agreed. Much of the changing activities of the banks had been difficult to identify pre-crisis, but German and French leaders now appeared to see the same evidence of the problems in more market-based systems as the Commission and the Liikanen Group. The stage seemed set for significant regulatory constraint on the move to market-based banking. Yet the ring-fencing case shows France and Germany defending the trading activities of their largest banks. National authorities acted in defense of their universal banks, but the activities they were defending reflected the changes that had occurred in such banking. The European Commission had grown highly skeptical of the social utility of market-based banking, particularly within the largest banks (Interviews Commission 2014, Commission 2015). In contrast, the French and German authorities who had borne the costs of these trading and market-based activities, sought to defend these activities because it was their largest, banking champions that were now conducting them.

Ring-fencing is only one of the many regulatory initiatives currently under way, although it is potentially amongst the most significant (on the UK, see Bell and Hindmoor 2014). We must also be cautious in reaching conclusions based on an ongoing debate (*ibid.*). However, the implications of French and German actions in this area could prove significant for financial system development in the two countries. On one level, France and Germany are simply defending their national champions, a long-standing component of *dirigiste* and post-*dirigiste* (Clift 2011) French policy in particular. On another level, that defense shapes the nature of the their financial systems away from market-based finance as an alternative to bank-based finance, and towards a market-based system dominated by market-based banks. Furthermore, it is the fragility of these market-based banks that the financial crisis revealed.

We employ detailed analysis of the various proposals and the authorities' public statements regarding ring-fencing, in conjunction with two further important data sources: first, the written responses of the banks, national and European-wide industry associations, and national regulators, central banks and governments, to the Liikanen Report and the EU Commission proposals. Over the three periods of consultation, the Commission received 708 responses from individual banks and banking associations, other financial institutions and their representatives, representatives of individual and corporate bank customers, public authorities and other interested parties. These responses are a valuable source of data regarding national and sectoral positions regarding the various proposals. Second, we conducted two rounds of interviews with EU officials, national regulators, national finance ministries, national and European banking associations, policy research units and lobbying groups.

To show why the French and German ring-fences took the shape that they did, the article is structured as follows: In the first section, we introduce market-based banking in greater detail, before explaining ring-fencing and the threat a stringent ring-fence would pose to market-based banking. The second section focuses more specifically on the domestic politics of banking reform in France and Germany. Here we show that the debate on ring-fencing emerged in the context of domestic bank failures. Before we can explain the specific form of the national ring-fences though, we then deal with an important point in our argument, explaining that the French and German reforms were a deliberate response to the perceived threat of a tougher European ring-fence looming on the horizon. In the third section then, we move the argument one step further, by examining what was really at stake in the domestic reforms. We do this by examining the claims made by France and Germany against the real implications of a stringent ring fence. We show that the claim of an impact on domestic lending was highly questionable, and that it was the trading activities of the large French and German banks that were threatened, and which the national authorities sought to protect. We then conclude.

Market-Based Banking (MBB) and Ring-fencing

Market-based banking

When it comes to conceptualising changes both *within* markets and *between* state and market actors across systems – synchronically and diachronically – by far the dominant approach has been the Varieties of Capitalism literature. Unfortunately, the VoC literature has long relied on conceptions of continuity and change in European financial systems that have now been surpassed by developments in banking. The traditional view contrasted European bank credit-based systems with Anglo-American capital market-based systems (e.g., Zysman 1983). On this reading, in credit-based financial systems banking institutions play a mediating role between household savers and entrepreneurs. They shield non-financial corporations (NFCs) from the pressures of financial markets (Rajan and Zingales 2003:12). A number of accounts, in the late 1990s and early 2000s, then pointed to the decline in importance of the traditional bank loan as a source of finance for European corporations (Hackethal et al 1999). The logical conclusion from a VoC perspective was convergence on an Anglo-American capital-market model and the decline of European banks. This view certainly appeared to frame French and German leaders' claims that the financial crisis was an Anglo-Saxon (read, capital markets) affair.

The empirical data, however, pointed in a different direction. Instead of a zero-sum game between banks and capital markets, the late 1990s and early 2000s were characterised by the rise of *market-based banking* (MBB). This involved two important changes: on the one hand, European banks – and the largest banks in particular – began to draw more heavily on wholesale sources of finance to fund lending activities, including through the use of securitisation. This differs from the traditional bank-based model, since the loan is most likely funded by another financial institution rather than by a depositor (Hardie et al 2013: 15). On the other hand, these same banks, under the guise of various forms of trading and related market-making activities, increased the size of their balance sheets by the purchase of very large volumes of trading assets, many of which subsequently caused insolvency-threatening losses. The dichotomy between banking and financial markets was replaced by a system where the two were deeply intertwined. Thus, simplistic claims about an Anglo-Saxon crisis – with diverse non-banking institutions as the catalyst – were misplaced. Instead, the shift towards market-based banking meant the crisis was very much one involving European banks.

It is also important to the ring-fencing debate that these European banks, including the largest in France and Germany, were historically universal banks. These large banks had always engaged, to varying degrees, in both investment banking and retail banking activities, and this detail helps to explain the two concerns that motivated the French and German ring-fences. Firstly, both French and German authorities had a long history of universal banking which appeared to suggest the centrality and utility of this particular banking model, even if the increase in trading activities pre-crisis had changed the investment banking component of universal banking. The scepticism which other ring-fence proposals displayed towards trading activities did not resonate with the French and German authorities. But secondly, this history of universal banks – that were also, often, national banking champions – made the threat to their trading activities a particularly potent one. The fear was not only that a tougher ring-fence would effectively lead these universal banks to wind-down key areas of market making-related activities, but also would open the door to US investment banks (Interview BdB 2015). In other words, whilst French and German authorities *spoke* of constraining financial market activity post-crisis, they acted to ensure that market-based banking remained an embedded feature of their domestic financial systems, and to defend the competitive position of their largest universal banks' trading activities.

How ring-fencing works

European banks' increased dependence on trading-related activities which were themselves dependent on holding high volumes of trading assets, rather than simply intermediating between customers, therefore made ring-fencing – or the separation of banking activities – a particularly sensitive issue. Ring-fencing aims to reduce the likelihood of future government support for banks and the impact of problems in high risk trading on the real economy. Proposals vary in two broad ways: scope and strength. Scope refers to the question 'What is being separated?'; Strength (or 'the height of the fence') mainly distinguishes between, on the one hand, separation of activities within a banking group - with further variation in the degree of functional separation within the group – and, on the other hand, ownership separation, the result of an outright prohibition on banks carrying out certain activities. As discussed below, there are two further differences between the proposals: 1) the distinction between mandatory separation and separation at regulators' discretion in the event that the activities separated are deemed a threat to the stability of a bank; and 2) proposals applying to all banks or only to the largest.

The degree of functional separation is determined by a range of factors covering legal, economic, governance and operational separation (see EU Commission 2014: 8). Reform proposals could vary across the range of issues, with greater separation in one area and less in another. Much of the discussion has focused on the technical issue of resolution in the event of bank failure, with the intention that the 'deposit-taking bank' should be sufficiently independent of the 'trading bank'[1] to be able to continue operating in the event of trading bank failure. While governance and operational separation issues were of some concern to the banks, not least for cost reasons, economic separation is clearly the most important issue for them. It is therefore our focus in this article. Within the issues surrounding economic separation, the important overall issue of *functional* separation for the banks lies in the extent to which the deposit-taking bank is prevented from supporting the trading bank during its operations. The banks' fear is that a lack of support from the deposit-taking bank will increase the financing costs of the trading bank, limiting its profitability. This might result in a larger universal bank scaling back its trading operations – opening the door to foreign trading institutions. Ring-fencing is therefore a highly politicised issue. For this reason the next part of the paper shows why the French and German authorities felt the need to use their national reforms to protect MBB in their domestic systems.

The domestic politics behind French and German ring-fences

In this section we show that although the national debate on ring-fencing emerged in the context of failures in the French and German banking system, it was fundamentally shaped as a response to the perceived threat of a tougher set of EU reforms. We will then examine the national reforms in greater detail and show how they tried to protect MBB in the largest banks.

France

The negative consequences of the 2007-09 banking crisis were significant for the French banking system, though less dramatic than for the German system (Hardie et al 2013: 12). For example French banks, in their response to Liikanen, were able to claim that they had not imposed direct losses on the French state. This was attributed

[1] The precise definition of these terms will depend on the scope of separation, i.e. which activities can be included in each type of bank.

in part to the comparatively conservative lending practices and the supervisory coverage of all lending institutions (IMF 2010a: 6). Yet the French crisis experience was very much an affair of two halves. As the banking crisis became a sovereign debt crisis, the resilience of the banks was truly tested by their poor cross-border lending decisions and investments in southern European banking. By 2012 the size and complexity of the French banks, as well as their overdependence on wholesale funding, became apparent (IMF 2012: 6).

Though the lack of exposure to securitization and securitized products shielded the banks from the 2007-09 phase of the crisis (Hardie and Howarth 2009:1017, Howarth 2013: 369), their expansion into international banking, particularly in periphery Euro-area countries ($677bn at end 2011), impacted profit margins from 2011 onwards, during the 'second phase' (IMF 2012: 11). French banks were also among the largest global players in equity derivatives, and although this part of the universal banking model had allowed them to diversify their income, credit rating downgrades of European banks (including BNP Paribas and Société Générale) late in 2011 made these derivatives transactions yet more costly (Deutsche Welle 2011). Moreover, reduced domestic retail activity made trading-related losses even more apparent than when they were balanced by strength in domestic retail operations (Banque de France 2012: 16).

Most importantly for the ring-fencing debate, these challenges in the French banking system coincided with the presidential campaign. Bank structural reform was high on the agenda of presidential candidate François Hollande, who declared in his first major campaign speech (January 2012) that his goal was to 'conquer' the banks, including through enforced separation of commercial and investment banking activities, and a ban on financial products 'not linked to the needs of the real economy' (cited in FT 2012a). Outgoing president Nicolas Sarkozy had similarly promised a more radical and adversarial approach to the largest French banks during the earlier phase of the crisis. In reality, however, the Sarkozy government had continued in its highly supportive stance towards the financial community, and rejected structural separation within the French banks (Jabko and Massoc 2013: 565).

Where Sarkozy's promises were little more than political rhetoric, Hollande initially appeared genuinely more interested in bringing substantive reform to the crisis-ridden banking sector. Hollande's proposals sprang from the recommendations of the Committee on Vigilance and Economic Analysis (Vigi-Eco) which he had formed and presided over. The first recommendation of Vigi-Eco was full separation of the banks, a step it was claimed would have 'gone even further than the Vickers recommendations' (Jean Peyrelevade, former CEO of Credit Lyonnais, cited in La Tribune 2012). Following the Presidential victory, Hollande then tasked Pierre Moscovici, the Finance Minister, with fleshing out the details of the reforms. In July 2012, Moscovici formally launched the Hollande government's banking structure reform, steered by the *Conseil de régulation financière et du risque systémique* (COREFRIS). It was directed by the President to separate banking activities that were useful to the economy and investment, from those that were purely speculative (COREFRIS 2012: 1), an apparent signal of Hollande's genuinely tougher approach to the biggest banks. But the debate in the COREFRIS quickly focused on the effects that ring-fencing reforms in other countries, and at the EU-level, would have on

French universal banks' competitive position, especially with regards to US investment banks (FT 2012b). The COREFRIS therefore decided to wait until it had evaluated the conclusions of the Liikanen Report, which were due to be published in September 2012 (COREFRIS 2012).

As the Liikanen consultations drew to a close, it became increasingly apparent that the EU Commission was pressing the High Level Expert Group for a tough response. In contrast to what would unfold at the national level, the severity of the bank failures was translating into a stronger impetus for more stringent bank structural reform. During later consultations for example (May 2013), the Commission was particularly critical of the misalignment of incentives within the largest banks because of the support of retail deposits for high-risk trading (Commission 2013: 4-7). Indeed, the Commission's final proposals – released 29th January 2014 – reflected a concern that the banks had 'become…distracted in fulfilling their role in adding credit to the real economy and [had] focused more on financial trading among themselves' (Interview EU Commission 2014). In other words, the Commission viewed market-based banking in the largest banks as a threat to stability and a distraction from being a motor for economic growth (Interview EU Commission 2015). In the Commission responses to the early Liikanen reviews the threat of a tougher European set of recommendations became very apparent.

As the HLEG recommendations emerged, and particularly its treatment of other trading activities, French authorities responded by fleshing out their national proposals 'in a step back from the Liikanen Report' (OECD 2013: 12). The French Law on the Separation and Regulation of Banking Activities (*la loi de séparation et de régulation des activités bancaires*) was therefore deliberately intended to protect the domestic banking system, clearly weaker than the EU proposals, and involved minimal threat to the strengths of French universal banks (Thomson Reuters 2012: 2, Banque de France 2012: 55, Pierre de Moscovici 2013). What followed was a swift parliamentary process, with final adoption of the law in July 2013. Faced with tough recommendations from the Liikanen Report, French authorities sought to establish a weaker French banking reform law that would pre-empt and shape the subsequent EU Commission proposals of January 2014 (Reuters 2012).

Germany

For Germany, the desire for reform was strongly influenced by its banking system being one of the worst affected – in terms of total write-downs – in the world. The early phase of the financial crisis exposed not only the largest commercial banks – Deutsche, Dresdner, HypoVereinsbank, and (to a lesser extent) Commerzbank – to significant losses, but also the Landesbanken (Hardie and Howarth 2009: 1023). One source of this vulnerability, as elsewhere, was the importance of wholesale funding, especially for a number of smaller specialized banks (IMF 2009b: 18), but the main reason was the losses on assets – including US sub-prime – purchased as part of trading activities (Deutsche Bundesbank 2007: 67). These losses had high political salience in Germany, compounded by the Landesbanken benefiting from state government guarantees they had used to borrow cheaply.

On both the assets and liabilities sides of the German banks' balance sheets, therefore, market-based banking had led to vulnerability and weakness (Hardie et al. 2013; Hardie and Howarth 2013). During the first phase (2007-09), though, the socioeconomic consequences of the crisis were less obvious, much as they had been in France. The fact that wholesale funding was generally lower amongst the more traditional German banks, and that such wholesale borrowing as there was tended to be heavily dominated by longer-term, 'covered bonds' (*Pfandbriefe*) and bonds sold to the banks' own customers (as opposed to the shorter-term finance in the UK and France) meant that the fall in available funds for lending was less prolonged. This meant that lending by smaller savings and cooperative banks could rise steadily (Hardie and Howarth 2013: 119, IMF 2010b: 11). Yet by 2012 there was a growing concern that greater reform efforts needed to be undertaken to internalize the risks of the largest banks and change the business models of the Landesbanken (IMF 2012b: 1).[2]

As in France, much of the ongoing concern about the largest banks derived from their continued high exposures to debtors in peripheral economies like Spain and Italy (Bundesbank 2012a: 81). Further, whilst major German banks had reduced their holdings of asset-backed securities, the credit quality of these remaining securities was deteriorating (ibid.). Thus the legacy of crisis-prone securities, often bought as trading assets, 'continued to weigh on the German banking system' (Bundesbank 2012b: 34). The result was that 'restructuring measures to adapt the business model' of these larger banks were becoming increasingly important in the public debate on securing the recovery of the German economy (Bundesbank 2012a: 83).

In political terms, however, the debate on ring-fencing really gathered steam in the run-up to the 2013 federal election. The first German ring-fencing discussions were prompted by a 25 page long report by the Social Democratic (SDP) candidate for the Chancellorship, Peer Steinbrück, in September 2012. His proposals – though less rigorous than full separation – suggested that the traditional lending and deposit-taking business should be legally separated from investment banking. He explicitly cited the UK Vickers report as a source of inspiration for his recommendations (Handelsblatt 2012). The Merkel government hoped to neutralize the SDP by swiftly pushing the ring-fencing bill through (FT 2013). Yet in so doing the government's response quickly narrowed the focus to isolate a minor part of the overall trading business (see below). In part, this focus derived from losses in these proprietary trading activities during the crisis (Bundesbank 2012b: 36), but it also took its lead from the Liikanen recommendations' highlighting proprietary trading, and the leadership initiative of the French (see above).

The German banking reform took a similar, including similarly pre-emptive, approach both to defend features of its banking system and its flagship banks (Reuters 2014). It too proposed a Liikanen-light version of the ring-fence and took its lead from the French reforms (FT 2013). Following the release of the Liikanen recommendations (October 2012) and the French proposals (December 2012), the German government also outwardly expressed its willingness to take action based on the Liikanen Report. The German draft bill (*Entwurf eines Gesetzes zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen*), published 6th February 2013, however, deviated from the Liikanen recommendations much as the French draft law had (Bundestag 2013: 1-2). As was the case in France

[2] The federal government has long sought Landesbanken reform, but had been generally thwarted by the states.

the draft German bill was hurried through the legislative process, with the Bundestag voting on the Bill on 27th May 2013 (Handelsblatt 2013). Faced with tougher reforms starting to emerge at the EU level, both France and Germany chose to respond pre-emptively with weaker national-level regulation that would in reality have minimal impact on market-based banking in their large banks.

French and German defence in EU negotiations

In this section we show how the French and German authorities and their banks tried to represent their interests in the EU negotiations during the Liikanen process and then with the EU Commission. We first show that the major claim made by the national actors, that a tougher EU-level ring-fence would harm domestic lending, is questionable. The connection between trading activities and domestic lending was, at best, underspecified in the responses and is hard to justify empirically. In the second subsection, we then argue that – behind the rhetoric used at the European level – the national actors were primarily concerned to defend market-based banking and the competitive position of their largest universal banks. We explain the threat that a tougher ring-fence would have posed to the largest banks' trading operations; and show that the national reforms actually pursued a much lighter touch approach to the trading activities that were separated out.

"Vital trading activities"

Crucially, in their responses to the EU Commission and Liikanen the French and German actors (both public and private) claimed that the scope and the strength of the French and German reforms were designed to protect "vital trading activities" that were seen as integral to their respective domestic financial systems and the European universal banking model (Interview French Treasury 2014). The treatment of these other trading activities therefore formed the basis for much of the contestation with the Liikanen Group, the European Commission and – later – within the European Parliament (French—German Council Working Paper 2014).

In the German responses, savings, cooperative and mutual banks highlighted particular structures of mutual support, ownership and the provision of 'central banking' services to the group by a large bank that would be the target of the EU proposals. It also, however, involved issues that would be covered by broadly-defined trading activity (e.g., DZ Bank 2012:1). The European Association of Co-Operative Banks argued that that its banks 'near to the "real economy"…envisage serious difficulties in continuing serving their clients' if reforms were targeted at their larger institutions at the centre of their cooperative networks (EACB 2013: 3; also ESBG 2013: 12). However, these particular issues relating to economic separation, while important to the traditional business models in German savings and cooperative banking, could easily be dealt with by a derogation from the separation proposals, rather than through a broad watering down of the proposals (EU Commission 2014, 11). Defense of their traditional three-tier banking system did not justify the approach the German authorities took.

Despite this, other large, private commercial and mutual banks in both France and Germany generalized the concerns of the savings and co-operative banks to claims about the impact a tough trading ring-fence would have on domestic lending (BNP Paribas 2012:1, FBF 2012: 4, Société Générale 2012: 5-6, Credit Agricole 2012: 2).

Credit Agricole for example, made similar arguments in response to Liikanen and the Commission regarding the important role that the largest French universal banks play in intermediation and the transmission of liquidity and hedging services to smaller entities and corporates (Credit Agricole 2013: 4). Likewise the German Banking Association argued that separating trading activities 'would lead to higher costs that would hit bank customers in particular' with the return on securities being likely to drop, and risk hedging and corporate lending becoming more expensive (BdB 2012: 2). Similarly, the responses of the public authorities argued that the tougher EU-level measures risked harming the 'financing of the real economy' (Banque de France 2012: 2, French and German joint response 2012: 1, Autorité des Marchés Financiers 2013: 1, French and German joint response 2013:1).

More specifically, the French and German claims that a tougher ring-fence – which in the case of Liikanen would have separated out all trading activities and, in the case of the later EU Commission proposals, would have significantly increased the likelihood of separating out these market-making activities conducted in large volumes – were framed by a discourse defending universal banking more generally. Public authorities in particular repeatedly aligned a stricter separation of trading activities – even if only targeting the largest banks – as a threat to the strengths of universal banking in general. French and German authorities argued that 'universal banks bring benefits in terms of client services and more broadly that investment banking activities usefully contribute to the financing of the economy' (French and German joint response 2012: 1); they also emphasised the 'merits of the universal banking model in terms of resilience and diversification of risks' (Banque de France 2012: 1); and that a reform of banking structures 'should neither weaken this business model nor hamper those positive externalities' (Banque de France 2013: 1, see also French and German joint response 2013: 1-2). None of these responses made any attempt at defining investment or universal banking, or at specifying which of their myriad activities had these positive effects.

We argue that the national responses conflated two relatively distinct issues. These issues require unpacking if we are to understand what the national authorities and their banks were actually concerned about, and what their national reforms had sought to protect. The result, we will argue below, is that the separation of trading activities was much less of a threat to the real economy than both the banks and the authorities claimed. Nonetheless, the national actors perhaps assumed that – given the stagnant Eurozone recovery in 2012-13 – the EU Commission would be sympathetic to concerns that further bank structural reform would harm economic growth (Interview EU Commission 2015).

The largest banks clearly conduct high volumes of trading and also lend heavily to the domestic economy; and in the case of the German cooperative and savings banks the largest bank in the group also fulfils a role as "central bank" at the hub of a network reaching down to the smallest, local banks. But the extent to which a tougher trading ring-fence would impact on domestic lending and the health of the domestic economy is at best underspecified in both the empirical data and the consultation responses by both the largest banks and their authorities. To explain why a defense of so-called vital trading activities was less important than defending market-based banking in the largest universal banks, we must first unpick the claim that a tough ring-fence of trading activities would harm domestic lending. Since the banks themselves never specifically clarified the precise relationship between trading and lending we instead point to three issues which suggest that trading revenues were the banks' main concerns. First, it is clear that the large banks do indeed conduct large domestic lending operations. Figure 1 provides the bank-level data for France and Germany. Despite important differences between the two systems, the largest French and German private commercial banks are, unsurprisingly, significantly engaged in credit provision to the domestic economy. However, secondly, the central issue for domestic lending is the extent of wholesale funding of lending for the largest banks – that is the market sources used to facilitate this domestic lending. Neither the national or European ring-fences made any attempt to restrict wholesale funding of lending. Indeed, limiting more risky trading activities may reduce the cost of funding for the deposit-taking banks. The banks' arguments therefore depended on the more limited grounds of possible reduced secondary market liquidity in corporate bond and securitization markets; in other words, potential limitations on the sort of financial market development French and German governments had long pursued (see above). This represents a more limited claim, especially when set against the role of securitization in bank losses.

FIGURE 1: Assets held for trading & liabilities due to customers and banks (% total assets/liabilities)

Thirdly, Figure 2 shows the percentage of French and German bank assets comprised of financial assets and derivatives held for trading. The decline since the financial crisis is significant, but in both countries trading-related activities remain a significant part of bank balance sheets, even during recent periods of considerable market uncertainty. Furthermore, in Germany in particular, the aggregated data hides very significant variation between the large more market-based banks and their smaller, more traditional counterparts. In 2013, for example, trading assets and the positive value of derivatives made up 56% of Deutsche Bank's assets. It is clear from the data why the largest banks in both countries viewed any measure that impeded their ability to conduct large-scale trading activity as a threat.

FIGURE 2: Financial assets held for trading (% total assets)

When it came to lobbying at the European level then, the banks presented claims about the social utility of these trading activities. Member state governments joined them in seeking to protect (supposedly) vital trading activities at the large banks (French & German Working Document 2014). In contrast however, we argue that the claim that a tougher ring-fence would harm domestic lending is unjustified. Certainly, the largest banks did the most trading activity and also lent – to varying degrees – domestically, but this does not justify the link made between trading and domestic lending. The French and German authorities were not protecting traditional bank lending by their universal banks.

Behind the rhetoric

Instead, both the national reforms and the banks and authorities responses to Liikanen and the Commission were primarily motivated by a second concern: that the division of trading banks from deposit-taking banks would undermine the ability of European trading banks to engage in trading – thereby contributing to the development of European capital-market financing – and to compete with the large US investment banks, in the ways they had been prior to the crisis. In other words, this was a defense of a particularly European universal banking model that was focused not on a 'one-stop shop' for NFC clients, but rather on competing with the trading operations of the large US investment banks (Interviews ECON 2015, EBF 2015). In supporting the market-making activities of their large universal banks, however, the French and German authorities were also supporting the holding of large volumes of trading assets, a central component of MBB and, for the Commission and many others, a major cause of the financial crisis.

We show this in two ways: by examining the threat of foreign competition; and by explaining that, in the all-important details of the national reforms, the narrowest range of trading activities were actually selected for separation. First, the banks and authorities were at times explicit about the threat of foreign competition; they found though that the EU Commission was less sympathetic to this concern (Interview French Treasury 2015), which led them to focus on the 'harming domestic lending' claim. Late in 2012, as the French and German authorities discussed the potential impact of a tougher European ring-fence, the fear of foreign competition from US trading institutions came to the fore (Interview BdB 2015). It became clear that, if stricter separation were enforced French and German banks would likely 'withdraw their supply of these trading activities, even whilst the demand remained' (ibid.). The threat was that the demand would be met by foreign competitors (ibid.). As Christian Noyer, governor of the Bank of France, candidly admitted: 'the French state would have found itself with only the big Wall Street banks to place its debt. Companies would have only found Wall Street banks to finance their operations' (cited in FT 2012b). French and German authorities therefore feared that a tougher ring-fence would 'only keep the universal banking model for the medium-sized banks' (Interview French Treasury 2014). This would effectively be a 'gift to the Anglo-Saxon banks' (Pierre Moscovici cited in FT 2012b) for whom the details of the US Volcker Rule appeared unlikely to act as a material constraint. As Moscovici would later note in relation to the French reforms, 'I did not want to weaken the French banking system. I want it to be strong' (cited in Reuters 2012).

In presenting the argument regarding the threat of foreign competition to the Liikanen Group and the Commission, the banks' arguments were somewhat inconsistent: it was suggested both that the use of wholesale funding to support lending was evidence that deposit-taking banks did not support their trading arms – because they themselves had to borrow in the market; and that without mutual support between the two activities, European trading banks would suffer a crippling competitive disadvantage (e.g., Association of German Banks 2012; Crédit Agricole 2012). Nevertheless, this argument does have potentially greater validity than the claim of reduced domestic lending, and had a clear influence on national authorities (Interview French Treasury 2015). Smaller, less diversified trading banks would be likely to have lower credit ratings and higher funding costs than the existing large universal banks from which they would be separated (including because the Lehman precedent might be interpreted by financial markets as suggesting government support was less certain).

In years before the crisis, European universal banking underwent very significant changes. For the EU Commission, these changes were largely responsible for the financial crisis, and needed to be reversed through stringent ring-fencing (Interview EU Commission 2014).

A second way of understanding the interests underlying the preferences in the national responses to the EU negotiations is to examine the specifics of their national reforms. There was a significant degree of overlap between these two national reforms. The French law separated out any proprietary 'speculative' activities that a bank might be conducting (AMF 2013). The law also sought to distinguish these proprietary trading activities 'from those activities that are considered useful to financing the economy', by incorporating a series of exemptions focused on market-making activities. This is a key development, as it meant that the proposals were not focused on market-based trading activities in general, as Liikanen and (later) the Commission were, but rather on a minor part of these activities (see below). In Germany, the ring-fencing law prohibited speculative transactions which exceeded the specified thresholds. Rather than specifically label this a proprietary trading ban, this meant that only credit institutions that exceed certain thresholds were obligated to discontinue or separate certain activities (Interview BaFin 2014). This meant that only 10-12 German banks would be affected by the reform, reinforcing a central German aim of shielding its smaller banks from change (Interview BdB 2014). However, this protection of smaller banks did not conflict with EU proposals, which were also focused on the larger banks. Even for the largest banks though, the German proposals were more benign; under the German Act the affected banks would be able to transfer proprietary trading activities to a legally, economically and operationally separate entity within the group.

Prohibitions on proprietary trading allowed the French and Germans to meet the requirement to be seen to do something, by apparently dealing with 'speculative' activity without a major impact on their largest banks' trading businesses. Though bank specific data on levels of proprietary trading in the French and German systems are not readily available, various indicators demonstrate the relative insignificance of these activities to the largest banks. Figures from BNP Paribas support the findings of the Liikanen and Vickers Commission reports, which both indicate that proprietary trading has been declining to an insignificant component of even the largest European banks' balance sheets in the period since the financial crisis. Between 2007 and 2014, even under a broad definition, proprietary trading assets within BNP Paribas fell from €630m to only €108m (BNP Paribas, financial statements, various years). One of the largest German banks, HypoVereinsbank, discontinued proprietary trading by December 2010 – ahead of the German reforms (HypoVereinsbank 2010: 59). Detailed information given to the European Commission estimated that proprietary trading contributed only 0 – 4 per cent of total trading revenues, which are in turn a small part of overall revenues (EU Commission 2014b: 248). Bank submissions regarding other reform proposals support this substantial post-crisis decline (ibid., 56), with the Association of German Banks specifically stating that its members had 'virtually dropped proprietary trading' by the time of its written response in mid-2012 (BdB 2012:9). Either because banks expected to lose this battle at the supranational level, or because their business plans did not envisage a return to this particular activity anyway, neither an outright ban nor the separation of narrowly defined proprietary trading represented a significant restriction on banks' revenue generating capacity from trading activities. In contrast to the EU proposals, the French and German laws – though ostensibly concerned to reduce higher risk, non-client-serving trading activities – simply reflected a move away from proprietary trading which had already taken place within the banks.

In sum, neither the proprietary trading ban nor the specific national ring-fences posed a significant challenge to the market-based activities of the largest French and German universal banks. Proprietary trading was targeted for functional separation, but only the lowest level of separation; and proprietary trading was itself a very minor part of overall trading activities. Any further scope for separation, to include market-making, was subject to the discretion of the national regulator, and only deemed to be necessary if that market-making activity was seen to be a threat to the stability of the bank or the financial system. Even then, the requirement was for the lowest strength of separation (Deloitte 2013: 16, French and German Working Party 2014: 2).[3]

Conclusion

In January 2012 the EU Commission finally published its proposals. It acted as French and German actors had feared it might – following the signals it had given during the Liikanen process – and proposed a tougher form of ring-fence. It neither believed the claim that a tougher ring-fence would harm domestic lending, nor did the Commission see the threat of foreign competition as sufficient grounds to weaken its demands for bank structural reform. Where national authorities had therefore acted to defend two key aspects of market-based banking, the Commission proposals threatened MBB (Interview French Treasury 2015). When the Commission proposals were announced, they were significantly more constraining on the large banks than the French and German proposals.

The relatively more expansive and stringent measures proposed by the EU Commission – in terms of the degree of functional separation, the range of activities to be ring fenced, and the potentially tougher thresholds – reflected a more sceptical European approach to the largest banks' ability to conduct large-scale trading activities and retail banking activities under the same roof safely. In their view, 'balance sheet expansion, highly leveraged, lack of market discipline, lack of bank resolvability, excessive risk-taking, trading and market-based activity, implicit bailouts expectations, competitive distortions, and conflicts of interest' had led to the financial crisis (EU Commission 2013: 2). This conclusion therefore justified a tough set of structural reforms that could reverse the move to market-based banking in European universal banking, particularly amongst the largest banks.

Explaining *why* the EU Commission adopted this more sceptical approach is beyond the remit of this article. Our interviewees, however, pointed to three overlapping explanations: one was the political pressure from social democrats and Greens in the EU Parliament; another factor may have been a deliberate bargaining strategy by the Commission, in the expectation that its tougher proposals would be watered down in the legislative process. A third explanation however, which fits best with the empirical record, was that the timing of the Liikanen and Commission proposals coincided with a more widespread EU-level aim to reduce the threat posed by the

[3] Working document #9, Working Party on Financial Services, France and Germany, from within EU Parliament.

largest banks to the safety of the Eurozone itself (Interview EU Commission 2015). This widespread concern shaped a series of other important EU banking reforms, including Banking Union (see Howarth & Quaglia *this issue*) and the Recovery and Resolution Directive.

Despite the extensive costs incurred by the financial crisis through bailouts and guarantees, and despite their ostensibly 'bank-based' financial systems, domestic authorities remained convinced that a universal banking model that now included high levels of market-based trading activity merited continued political support. This was not an attempt to protect traditional bank-based financial systems, as the Varieties of Capitalism literature would imply. Member state governments were in fact responding to changes in the nature of universal banking in their own financial systems, with increased dependence on trading assets. These changes also reflect developments in the business models of investment banking, and an equally potent threat from US investment banking competitors (Interview BdB 2015). A fuller understanding of national positions therefore requires both the focus on the implications of the change within national banking systems that the CPE literature is now recognizing, and of the implications of the changes in international finance that have generally been more the focus of international political economy.

These developments have important implications for how we see influences on systemic change in financial systems within the EU. The EU Commission has long taken on the role of pushing financial market development (Macartney 2010). It has also frequently faced European governments eager to protect the distinctive features of their domestic systems that have favoured more traditional banking practices. French and German 'market making' initiatives before the crisis were in the direction of developing financial markets, not at increased bank trading assets. Despite this national government activity, the large universal banks have increased their reliance on market-based trading assets, most notably as a result of international trading activities. A strong case can be made that this increase in market-based banking played a central role in the financial crisis. This was certainly the view that the Commission expressed in its responses (see also Epstein & Rhodes, *this issue*). The aim was still market integration; but the regulatory approach to achieving this goal had tightened, reflecting a recalibration of what had been considered benign financial activity going on within the largest banks (Macartney 2014). A significant regulatory reversal in the move towards increasingly market-based banking might be expected. Faced with the changing nature of their large universal banks, especially their dependence on trading, national authorities have balked. Despite a degree of change in the ideas underpinning the European Commission's approach to banking regulation, the move to increasingly market-based banking will continue. The banks' 'too big to separate' argument has won through.

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